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BEFORE THE

Federal Communications Commission

WASHINGTON, DC 20554

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JUL 17 1998

FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

In the Matters of	)	
	)	
1998 Biennial Regulatory Review — Review of Accounting and Cost Allocation Requirements	)	CC Docket No. 98-81
	)	
United States Telephone Association Petition for Rulemaking	)	ASD File No. 98-64

COMMENTS OF U S WEST, INC.

James T. Hannon
U S WEST, Inc.
Suite 700
1020 19th Street, N.W.
Washington, D.C. 20036
(303) 672-2860

Its Attorney

Of Counsel,
Daniel L. Poole
U S WEST, Inc.

Kathryn A. Zachem
J. Wade Lindsay
Wilkinson, Barker, Knauer & Quinn LLP
2330 N Street, N.W.
Washington, D.C. 20037
(202) 783-4141

Date: July 17, 1998

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SUMMARY

In the *Accounting NPRM*, the Commission proposes to raise the threshold for required Class A accounting procedures in order to permit mid-sized incumbent local exchange carriers (with annual operating revenues of less than $7 billion) to use the less restrictive Class B accounting procedures. The Commission also proposes less burdensome cost allocation manual ("CAM") procedures and a reduction in the frequency with which independent audits of the cost allocations are required for the same mid-sized carriers. According to the Commission, leaving large incumbent local exchange carriers subject to the more detailed Class A account system and cost allocation procedures is necessary to monitor these carriers as competition begins to develop and to uphold the Commission's statutory obligations under Sections 254(k), 260, and 271-276 of the Communications Act.

On February 19, 1998, the United States Telephone Association provided the Common Carrier Bureau with written proposals to simplify the Commission's accounting and cost allocation rules for *all* incumbent LECs. Ameritech Corporation, Bell Atlantic, BellSouth Corporation and SBC Communication Inc., also provided written recommendations for streamlining and simplifying the accounting and cost allocation rules. The *Accounting NPRM*, however, ignores virtually all of these proposals.

U S WEST strongly disagrees with the Commission's tentative conclusions. The existing accounting and cost allocation rules impose unnecessary and costly constraints upon incumbent LECs. Moreover, less burdensome alternatives are available to protect against the potential for anticompetitive behavior, yet the Commission failed to explore these alternatives. U S WEST submits that existing regulations no longer serve the public interest. Further, modification or repeal of these rules is essential to further the industry's move to a competitive and deregulatory environment. However, insofar as this goal may not be accomplished immediately, U S WEST supports the recommendations for streamlining the existing rules on an interim basis made by the United States Telephone Association and also contained in the report filed by Arthur Andersen LLP on July 15, 1998.

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COMMENTS OF U S WEST, INC.

U S WEST, Inc. ("U S WEST") hereby submits the following comments in the above-captioned proceeding.[1] U S WEST is a member of the United States Telephone Association ("USTA") and supports USTA's comments filed in this proceeding. These comments, however, serve to emphasize U S WEST's particular concerns with the *Accounting NPRM.*

I. INTRODUCTION/STATEMENT OF POSITION

On June 17, 1998, the Commission issued its *Accounting NPRM* proposing to modify its existing accounting and cost allocation rules.[2] Specifically, the Commission proposes to raise the threshold for requiring Class A accounting procedures in order to permit mid-sized incumbent local exchange carriers ("LECs") (LECs with annual operating revenues of less than $7 billion) to use the less restrictive Class B accounting procedures.[3] The Commission also proposes less burdensome cost allocation manual ("CAM") procedures and a reduction in the

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1 *See 1998 Biennial Regulatory Review — Review of Accounting and Cost Allocation Requirements; United States Telephone Association Petition for Rulemaking*, CC Docket No. 98-81, ASD File No. 98-64, *Notice of Proposed Rulemaking*, FCC 98-108 (rel. June 17, 1998) ("*Accounting NPRM*").

2 47 C.F.R. §§ 32.1 *et seq.* and 64.901 *et seq.*

3 *See Accounting NPRM* at ¶ 2.

frequency with which independent audits of the cost allocations are required for the same mid-sized LECs.[4] The Commission finally proposes certain changes to its Uniform System of Accounts ("USOA") which will apply to all carriers subject to Part 32, not just the mid-sized LECs.[5]

The proposed modifications were made as part of the Commission's biennial review of its regulations mandated by Section 11 of the Communications Act. Section 11 requires the Commission, in every even-numbered year beginning in 1998, to review its regulations applicable to telecommunications carriers to "determine whether any such regulation is no longer necessary in the public interest as the result of meaningful competition between providers of such service."[6] The Commission is further required to "repeal or modify any regulation it determines to be no longer necessary in the public interest."[7]

The Commission announced its intention to include its accounting and cost allocation rules as part of its 1998 biennial review on February 5, 1998.[8] On February 19, 1998, USTA provided the Common Carrier Bureau with written proposals to simplify the Commission's accounting and cost allocation rules for *all* incumbent LECs. Ameritech Corporation, Bell Atlantic, BellSouth Corporation, and SBC Communication Inc., also provided written recommendations for streamlining and simplifying the accounting and cost allocation rules.

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4 *Id.*

5 *Id.* at ¶¶ 2, 13.

6 47 U.S.C. § 161(a).

7 *Id.* § 161(b).

8 *See* General Action, Report No. GN 98-1 (rel. Feb. 5, 1998).

The *Accounting NPRM*, however, ignores virtually all of these proposals. Indeed, the Commission did not even discuss the proposals submitted by USTA and other carriers. Instead, the Commission proposed to leave large incumbent LECs (which total nearly 90% of the industry for local exchange telecommunications) subject to the onerous Class A accounting and CAM procedures.[9] According to the Commission, these more detailed systems are required to monitor large incumbent LECs as competition begins to develop and is necessary for the Commission to uphold its statutory obligations under Sections 254(k), 260, and 271-276 of the Communications Act.[10]

U S WEST strongly disagrees with these tentative conclusions. As discussed in more detail below, the Commission's existing accounting and cost allocation rules impose unnecessary and costly constraints upon incumbent LECs. Moreover, less burdensome alternatives are available to protect against the potential for anticompetitive behavior, yet the Commission failed to explore these alternatives. U S WEST submits that the existing regulations no longer serve the public interest. Further, modification or repeal of these rules is essential to further the industry's move to a competitive and deregulatory environment.

This conclusion is consistent with the views expressed by Commissioner Furchtgott-Roth in his separate statement to the *Accounting NPRM*.

> I am becoming increasingly convinced that many of the current regulatory mechanisms — and certainly the level of detail — are no longer necessary in today's increasingly competitive environ-

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9 *Accounting NPRM* at ¶ 4. "Among incumbent LECs, this revision would limit Class A accounting to the Bell Operating Companies and the GTE Operating Companies. All other incumbent LECs could use the Class B system of accounts." *Id.*

10 *Id.* at ¶¶ 6, 10.

> ment. [The Commission] must develop a more forward-looking blueprint to guide the transition from regulation to competition.[11]

U S WEST concurs with Commissioner Furchtgott-Roth and submits that the Section 11 mandate to review existing regulations and to modify or eliminate those that are no longer in the public interest provides the Commission the opportunity to establish such a forward-looking blueprint. U S WEST therefore urges the Commission to revise its accounting and cost allocation rules so as to provide *all* LECs the flexibility necessary to prosper in today's competitive environment. Such revisions should not only streamline existing rules and systems but also should provide guidelines (or a blueprint) for moving the industry toward accounting, recordkeeping, and cost allocation practices which are generally used by publicly-traded companies.

II. THE COMMISSION SHOULD BEGIN TO MOVE TO A STRUCTURE IN WHICH ALL CARRIERS ARE PERMITTED TO COMPLY SOLELY WITH GENERALLY ACCEPTED ACCOUNTING PRINCIPLES

On July 15, 1998, Arthur Andersen LLP submitted to the Commission a report analyzing and identifying opportunities for simplifying and streamlining the Commission's accounting and cost allocation regulations.[12] The fundamental premise underlying this report is that the regulatory and competitive paradigm which originally justified the existing accounting and cost allocation rules is no longer valid.[13] Since 1988, when the existing rules were put into

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11 *Id.*, Separate Statement of Commissioner Harold W. Furchtgott-Roth.

12 *See* Arthur Andersen LLP, "Accounting Simplification in the Telecommunications Industry," (filed July 15, 1998) ("Arthur Andersen Report"). The report was prepared on behalf of a coalition of large incumbent LECs consisting of Ameritech Corporation, BellSouth Corporation, GTE Service Corporation, SBC Communications Inc. and U S WEST.

13 *See id.* at 10-13.

place, a number of events have occurred which have substantially changed the environment in which LECs operate. Of particular significance is the fact that all the large incumbent LECs are subject to price cap regulation both at the Federal level and in the majority of the states.[14] In addition, passage and implementation of the Telecommunications Act of 1996 has set the stage for the emergence of competition in virtually every segment of the communications marketplace.[15]

As Arthur Andersen demonstrates, however, the Commission's existing accounting and cost allocation rules do not reflect these regulatory and competitive realities. In effect, the existing rules have evolved into nothing more than regulation for regulation's sake without any significant benefit to the public interest. Consequently, the rules represent an unnecessary and costly regulatory burden upon LECs.

For example, the Commission's existing accounting requirements are intended as:

> a historical financial accounting system which reports the results of operational and financial events in a manner which enables both management and regulators to assess these results within a specified accounting period. The USOA also provides the financial community and others with financial performance results.[16]

In point of fact, however, the Part 32 accounting requirements no longer satisfy the purposes for which they were established.

Management for U S WEST and other large incumbent LECs no longer utilize the USOA to manage business. Further, the financial community no longer relies on USOA to analyze the incumbent LECs' economic performance. U S WEST and other large incumbent

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14 *Id.* at 10-11.

15 *Id.* at 11.

16 47 C.F.R. § 32.1.

LECs have discontinued utilizing the Statement of Financial Accounting Standards No. 71, "Accounting for the Effects of Certain Types of Regulation," in producing their audited financial statements for filing with the SEC and for publication to the financial community. In other words, the USOA serves neither internal management nor external reporting purposes for U S WEST; it is merely a second level of financial information maintained solely for Commission regulatory purposes.

Furthermore, in light of the drastic changes in the telecommunications industry, it is no longer clear that the Commission's accounting and cost allocation rules serve any significant regulatory purposes. The existing detailed Class A accounting and cost allocation requirements were established when incumbent LECs were regulated pursuant to traditional rate-of-return regulation. Such regulation required LECs to provide detailed plant asset balances and cost allocations so that the Commission could determine the propriety of the carrier's rate base. Similarly, detailed plant accounting records were used to determine the average service life of assets in order to set depreciation rates for assets in a carrier's rate base.

Today, however, U S WEST and the other large incumbent LECs are subject to price cap regulation rather than the rate-of-return regulation contemplated by the existing accounting and cost allocation rules.[17] Under price cap regulation, a carrier's rates are no longer based upon its cost-of-service plus a return on capital investment. In other words, the price for a given product or service is regulated without regard to the costs incurred and the plant investment utilized to provide such services. Thus, strict rules for allocating costs between regulated and unregulated activities do not serve to protect consumers because the level of costs allocated to regulated services have no impact upon the rates for such services. Consequently, the detailed

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[17] *See* Arthur Andersen Report at 10-11.

plant asset balances and accounting records are no longer relevant for Commission regulatory purposes.

Finally, insofar as competition has begun (and should continue) to enter the local exchange market, it is imperative that incumbent LECs be relieved of cumbersome and irrelevant regulatory requirements. In a competitive environment a carrier can thrive only where it has the flexibility to adjust its rates and accounting structures to respond quickly to changing market conditions. The existing accounting and cost allocation rules hamper incumbent LECs' flexibility to respond to market conditions. Moreover, carriers other than incumbent LECs are not subject to the Commission's accounting and cost allocation requirements and thus have a significant competitive advantage over incumbent LECs.

U S WEST therefore submits that the Commission should begin to move toward a structure in which *all* carriers are required simply to comply with generally accepted accounting principles ("GAAP"). These standards ensure that readers of financial statements have information which clearly and accurately reflects the nature of the financial transactions undertaken by the company. Further, the financial markets are assured that companies are following GAAP standards through audited financial statements filed with the Securities and Exchange Commission ("SEC"). Finally, subjecting all carriers to the same accounting requirements would "level the playing field" thereby promoting healthy and fair competition in the future.

U S WEST also concurs with USTA that the Commission should eliminate its Part 64 cost allocation system. In the existing environment of competition and price cap regulation, the costs of developing and maintaining cost allocation processes, audits, and reporting are a substantial burden upon U S WEST and other incumbent LECs which will significantly hamper their ability to compete in today's telecommunications market.

While elimination of the Commission's existing accounting and cost allocation requirements should be the long range goal, U S WEST accepts that this goal may not be accomplished immediately. As an alternative, the Commission should streamline the existing rules for all incumbent LECs on an interim basis.[18]

III. THE COMMISSION'S PROPOSAL TO CONTINUE CLASS A ACCOUNTING AND INDEPENDENT CAM AUDITING REQUIREMENTS FOR LARGE LECs IS WITHOUT MERIT

The rule changes proposed in the *Accounting NPRM* accomplish neither of the goals outlined above. The Commission proposes to relieve "mid-size" LECs (LECs with annual operating revenues less that $7 billion), but not "large" LECs, of the Class A accounting and independent CAM auditing requirements. Put simply, this proposal does nothing to relieve LECs that total nearly 90% of the industry for local exchange telecommunications from the onerous, expensive, and unnecessary accounting and cost allocation rules.[19]

As justification for this disparate treatment, the Commission states that:

> Class A accounting is necessary to properly monitor the largest incumbent LECs because these carriers tend to offer a large volume of competitive products and services, thereby creating numerous opportunities for these largest carriers to subsidize competitive services . . . Accordingly, we believe that these audits are required to monitor the large incumbent LECs as competition begins to develop in local telephony markets and are necessary for

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[18] U S WEST presents specific recommendations for modifications to the Commission's accounting and cost allocation rules in Part IV below. U S WEST believes these modifications will reduce the level of detail that must be maintained and increase the level of carrier flexibility in establishing its accounting and cost allocation systems.

[19] *Accounting NPRM* at ¶ 4.

> the Commission to uphold our statutory obligations under sections 254(k), 260, 271, 272, 273, 274, 275 and 276 of the Act.[20]

This rational is without merit.

The Commission's assumption that the largest incumbent LECs "offer a large volume of competitive products and services, thereby creating numerous opportunities for these largest carriers to subsidize competitive services" is wrong. As detailed in the USTA comments, large incumbent LECs do not offer a large volume of competitive products.[21] Data derived from the 1997 Automated Reporting and Management Information System ("ARMIS") reports indicate that on average only 7% of large incumbent LECs' total costs are assigned to competitive products and services, only 6% of total operating revenue is derived from such products and services, and only 2% of the plant in service is used to provide competitive products and services.[22]

Further, with the advent of price cap regulation for the large incumbent LECs, cost of service no longer bears a direct relationship to the prices charged for any given product or service.[23] In other words, price cap regulation severs the fundamental connection between cost and price. As a consequence, concerns regarding cross-subsidization of competitive services are no longer valid in a price cap environment.

Furthermore, it is unclear whether the detail required by Class A accounting is necessary for the Commission to uphold its statutory obligations under Sections 254(k), 260, and

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20 *Id.* at ¶ 12.

21 *See* USTA Comments at 8.

22 *Id.*

23 *See* Arthur Andersen Report at 11.

271-276 of the Communications Act. According to the Commission, Class A accounts provide a more "refined" level of cost accounting than Class B accounts thereby allowing the Commission to more accurately identify misallocations.[24] Again, however, under the existing price cap regime, the nexus between cost allocation and rates have been severed rendering the "refined" cost accounting of Class A accounts unnecessary for Commission purposes.

Finally, the Commission concludes that maintaining Class A accounting requirements for the largest incumbent LECs imposes no significant burden because such carriers already maintain their financial records in much greater detail for managerial decision-making and other purposes.[25] As the Arthur Andersen Report makes clear, however, large carriers now use charts of accounts and accounting systems that differ significantly from the USOA.[26] Put simply, the Class A accounts are used only for regulatory reporting purposes requiring U S WEST and other large incumbent LECs to maintain two levels of the same financial information — one for regulatory purposes and one for managerial purposes. This duplication of effort is burdensome, costly, and provides no benefit to the consumer or the company.

U S WEST submits therefore that there is no basis for the Commission to distinguish between mid-size and large incumbent LECs for imposing Class A accounting requirements.

IV. INTERIM RECOMMENDATIONS

As discussed above, U S WEST submits that elimination of the existing accounting and cost allocation requirements should be the Commission's long range goal. Insofar as this

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24 *Accounting NPRM* at ¶ 6.

25 *Id.*

26 *See* Arthur Andersen Report at 16-19.

goal may not be accomplished immediately, U S WEST offers the following recommendations for streamlining the existing rules on an interim basis.

A. Part 32 Accounting Requirements

U S WEST generally supports the revisions to the Commission Part 32 accounting requirements recommended in the Arthur Andersen Report.[27] The Commission should allow all LECs to use Class B accounting.[28] This action would reduce the level of detail that U S WEST would have to maintain solely for regulatory accounting purposes. Further, it would give U S WEST greater flexibility and efficiency in managing its business in increasingly competitive telecommunications markets. Moreover, as discussed above, insofar as U S WEST is subject to price cap regulation, the additional detail required by Class A accounting is no longer relevant for Commission regulatory purposes.

In addition, the Commission should eliminate the requirement that carriers maintain an expense matrix for each Part 32 expense account for salaries and wages, benefits, rents, or other expenses.[29] Tracking and maintaining these expenses is costly and time consuming, it is not used for management or external reporting purposes, and has little relevance under price cap regulation.

LECs should also be permitted to follow GAAP materiality levels. The current requirement that a carrier's financial information be recorded regardless of the item's "materiality" under GAAP,[30] significantly undermines a carrier's flexibility. The restriction essentially

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27 *See id.* at 21-24.

28 *Id.* at 22-23.

29 *Id.* at 23.

30 47 C.F.R. § 32.26.

creates a cost burden upon incumbent LECs which is not present for competing companies.[31] For the same reasons, the Commission should eliminate the prenotification requirements related to contingencies, extraordinary items, and new accounting standards.

B. Depreciation and Amortization

U S WEST also agrees with the Arthur Andersen recommendations to permit LECs to set depreciation lives, amortization periods and rates based upon each carrier's particular circumstances all in accordance with GAAP.[32] As Ameritech notes in its March 13, 1998 filing, there is no legal obligation for the Commission to set depreciation rates for price cap carriers.[33]

Further, depreciable lives that are no shorter than the economic lives determined for use on a company's external Financial Reporting books should be permissible. These books are required to meet GAAP criteria as well as securities and other laws, and are subject to external audit on an annual basis.

Permitting LECs the flexibility to set economic depreciable lives and amortization periods would make these determinations more realistic in that LECs would have greater freedom to take into account the many countervailing influences in the financial and business environment. Such competing influences ensure that a company will establish economic lives that are meaningful and within appropriate ranges for financial reporting purposes.

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31 Arthur Andersen Report at 19.

32 Arthur Andersen Report at 35-36.

33 Letter from Robin Gleason, Director — Regulatory Finance, Ameritch to Kenneth P. Moran, Division Chief, Accounting and Audits Division. at 1 (dated March 13, 1998).

U S WEST notes the possible concern that utilizing SEC depreciable lives and amortization periods could cause a LEC's earnings to go below the Lower End Formula Adjustment level. If such a situation did arise, however, the Commission would remain free to review the LEC's depreciation and amortization parameters and rates for reasonableness. In other words, LECs would continue to be subject to review on an as needed basis.

C. Continuing Property Records

In addition, U S WEST agrees with the Arthur Andersen recommendation that the Commission should substantially revise its detailed requirements regarding the manner in which records for retirement units and property records must be maintained.[34] The requirements regarding continuing property records ("CPR") are extraordinarily burdensome and serve no significant regulatory or business purpose.[35] Indeed, U S WEST has been forced to create additional records, work-around processes and redundant data in order to meet both its ordinary business needs and the current CPR requirements. LECs should have the flexibility to maintain records that conform to GAAP criteria, meet ordinary business needs, and satisfy internal control requirements, without having to meet the separate and more detailed requirements set forth in the existing regulations. Such flexibility would give LECs the ability to utilize records for multiple business and reporting purposes and eliminate records that serve no business purpose.

D. ARMIS Reports

U S WEST agrees with Ameritech that the Commission should streamline and consolidate the ARMIS reports to the greatest extent possible. For example, as demonstrated in Ameritech's March 13, 1998 filing, several schedules on the ARMIS 43-02 Report require

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[34] 47 C.F.R. § 32.2000(f); Arthur Andersen Report at 34.

[35] Arthur Andersen Report at 34.

information which is no longer significant for price cap carriers.[36] Consistent with its discussion above, U S WEST submits that carriers should not be required to expend the time, effort, and resources necessary to compile and file information that is no longer relevant to their regulatory status. To that end, U S WEST submits that, at a minimum, the ARMIS 43-01, 02, and 04 reports should be consolidated into one report which can provide necessary information without creating overly burdensome and redundant reports.

E. Part 64 CAM Simplification

As discussed above, the allocation of costs to regulated and unregulated activities serves a greatly diminished purpose under the existing system of price cap regulation. As a consequence, the existing Part 64 CAM requirements are overly complex, burdensome, and costly for the regulatory purposes they serve. U S WEST submits that the CAM requirements can be greatly streamlined and simplified without any material reduction in the protection for ratepayers. Consequently, U S WEST supports USTA's proposals for simplifying the Commission's Part 64 CAM requirements including the elimination of: (1) the 15-day notice requirement; (2) the requirement to quantify CAM changes; (3) the nonregulated product matrix from the CAM; and (4) the requirement to treat competitive tariffed regulated services as nonregulated for accounting purposes.

F. Affiliate Transactions

The existing system of price cap regulation prohibits incumbent LECs from raising rates to cross-subsidize its nonregulated services. Consequently, the existing regulatory structure provides ratepayers with significant protections, and the Commission should be able to simplify the CAM requirements regarding affiliate transactions with little, if any, reduction in

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[36] Ameritech Letter at 2.

protection for ratepayers. To that end, U S WEST also supports USTA's proposals to simplify CAM requirements with regard to affiliate transactions.

U S WEST is particularly supportive of the USTA proposal to establish a *de minimis* threshold for listing entities on the chart of affiliates and for reporting affiliate transactions. Carriers should be required to include in the chart of affiliates only those entities that have assets in excess of $10 million and to report only those services between affiliates for which the aggregate annual revenue exceeds $100,000. This proposal would eliminate the reporting of affiliates that are insignificant in size and of those affiliate transactions which have no material impact upon LEC revenues.

CONCLUSION

In light of the above, U S WEST urges the Commission to revise its accounting and cost allocation rules so as to provide *all* carriers the flexibility necessary to prosper in today's competitive environment. Such revisions should not only streamline existing rules and systems but also should provide guidelines (or a blueprint) for moving the industry toward accounting, recordkeeping, and cost allocation practices which are generally used by publicly-traded companies. Accordingly, U S WEST requests that the Commission implement its interim recommendations to streamline the accounting and cost allocation rules until such time as the rules can be revised and/or repealed as necessary to give all carriers the necessary accounting flexibility.

Respectfully submitted,

U S WEST, Inc.

By: James T. Hannon

U S WEST, Inc.
Suite 700
1020 19th Street, N.W.
Washington, D.C. 20036
(303) 672-2860

Its Attorney

Of Counsel,
Daniel L. Poole
U S WEST, Inc.

Kathryn A. Zachem
J. Wade Lindsay
Wilkinson, Barker, Knauer & Quinn LLP
2330 N Street, N.W.
Washington, D.C. 20037
(202) 783-4141

Date: July 17, 1998

CERTIFICATE OF SERVICE

I, Shelia L. Smith, hereby certify that I have on this 17th day of July, 1998 caused a copy of the foregoing Comments of U S WEST, Inc. to be served by first class U.S. mail, postage prepaid, to the following:

The Honorable William E. Kennard*
Federal Communications Commission
1919 M Street, N.W., Room 814
Washington, D.C. 20554

The Honorable Harold Furchtgott-Roth*
Federal Communications Commission
1919 M Street, N.W., Room 802
Washington, D.C. 20554

The Honorable Susan Ness*
Federal Communications Commission
1919 M Street, N.W., Room 832
Washington, D.C. 20554

The Honorable Michael Powell*
Federal Communications Commission
1919 M Street, N.W., Room 844
Washington, D.C. 20554

The Honorable Gloria Tristani*
Federal Communications commission
1919 M Street, N.W., Room 826
Washington, D.C. 20554

Warren Firschein*
Accounting Safeguards Division
Common Carrier Bureau
Federal Communications Commission
2000 L Street, N.W., Suite 200
Washington, D.C. 20554

International Transcription Service
1231 20th Street, N.W.
Washington, D.C. 20036

Shelia L. Smith
Shelia L. Smith

*By Hand